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An Examination of Corporate Income Tax Credits

Prepared for the Citizens Finance Review Commission

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1. WHAT IS A CORPORATE INCOME TAX CREDIT?

A corporate income tax credit lowers the amount of tax liability paid by a corporation. This reduction in tax liability reduces general fund revenue. Since income tax revenues are shared with cities and towns, tax credits also reduce the amount of revenues going to cities and towns.

Credits vs. Subtractions¹ Tax credits are subtracted directly from tax liability. A subtraction from federal taxable income² also reduces tax liability but less directly than a tax credit. A dollar of tax credit is worth a dollar of tax liability; a dollar of subtraction is worth a maximum of \$.06968 in liability. To illustrate:

Federal taxable income	\$10,000
Arizona taxable income	\$10,000
Tax liability at 6.968%	\$696.80
Credit	\$500
Net tax liability	\$196.80

Federal taxable income	\$10,000
Subtraction	\$500
Arizona taxable income	\$9,500
Tax liability at 6.968%	\$661.96

With neither a credit nor a subtraction, tax liability would be \$696.80. A \$500 tax credit reduces tax liability to \$196.80. A \$500 subtraction reduces tax liability to \$661.96.

Refundable vs. Nonrefundable Credits can be refundable or nonrefundable. A refundable tax credit removes any tax liability and any remaining tax credit is refunded to the taxpayer. For example:

Tax liability	\$1,000
Refundable tax credit	\$5,000
New tax liability	\$0
Refund	\$4,000

Two credits, the Agricultural Preservation District Credit and the Technology Training Credit, are refundable. (The Alternative Fuel credits were also refundable but have been repealed.)

A nonrefundable credit offsets any tax liability and generally has a designated period for which any unused credit can be carried forward. Only one nonrefundable credit currently available in Arizona, the Underground Storage Tank Credit, has no carry forward period allowed. Two nonrefundable credits currently available in Arizona (the Environmental Technology Facility

¹ Subtractions, exemptions and deductions all affect tax liability in the same way.

² Federal taxable income is the starting point for the calculation of Arizona tax liability and comes from the federal form 1120.

Credit and the Research and Development Credit) have a carry forward period of 15 years. Unused Defense Contracting Credit can be carried forward until 12/31/11. All other nonrefundable credits now available have a five-year carry forward period.

2. HOW CAN CREDITS BE EVALUATED?

The CFRC has set out a series of working principles against which changes in the state's revenue structure should be measured. Most of these principles do not apply to corporate income tax credits. **Corporate credits do not promote horizontal equity, vertical equity, revenue stability for the state, simplicity, predictability, efficiency or reliability.** Corporate income tax credits are a method to try to set social policy through the tax system, which makes the tax system more complex.

There are circumstances, however, in which tax credits may be a necessary tool. Set out below are modified principles which could help in determining the effectiveness of a corporate income tax credit.

- Competitiveness: Do targeted states³ offer a similar credit?⁴
- Social Policy: Has the credit encouraged taxpayers to participate in the desired behavior to a greater degree than before the credit was offered?
- Economic Development: Has the credit been successful in attracting new corporations to Arizona? Have jobs been increased as a result of the credit? Has there been any stimulation of capital investment or industry retention or expansion attributable to the credit?
- Compliance: Are the records required to claim the credit a substantial burden for the taxpayer?⁵
- Administration: Is the credit burdensome for the state to administer?

³ The CFRC has identified California, Colorado, Florida, Georgia, Nevada, New Mexico, Oregon, Texas, Utah, and Washington as Arizona's competitors. Nevada has no corporate income tax or franchise tax and, therefore, no corporate income tax credits.

⁴ Corporate income tax returns for the targeted states with corporate income tax were reviewed to determine the availability of similar credits.

⁵ Some would argue that whether or not the credit is burdensome to the taxpayer is not really relevant. The corporations are aware of the record keeping required for the credit before they take the credit; therefore, if they want to take advantage of the tax break they should expect to have to keep the records. It has been referred to as "the price of admission."

3. WHAT CORPORATE INCOME TAX CREDITS ARE AVAILABLE?

There are currently 14 credits available to corporate income taxpayers⁶. All credits are enacted to promote specific corporate behaviors. The types of behavior being encouraged can be sorted into three groups. Within each of these groups, the particular credits are discussed. For a more detailed description of the credits, contact the Arizona Department of Revenue.

All cost figures cited here reflect data gathered through tax year 2000. Little data has been gathered yet for tax year 2001 or later. Additionally, because it is not uncommon for corporate income tax returns to be amended several years back, the numbers will change as newly-filed returns are reviewed.

Credits Enacted for Environmental Concerns The four credits in this category are similar in that they each relate to an environmental concern.

Agricultural Pollution Control Equipment Credit

Statute: A.R.S. § 43-1170.01

Purpose: This credit is allowed for purchases of property used in the taxpayer's business to control pollution. The taxpayer's business must involve livestock or agriculture. Property that qualifies for this credit includes the portion of a structure, building, installation, excavation, machine, equipment or device and any attachment or addition or reconstruction, replacement or improvement of that property that is directly used, constructed or installed to prevent, monitor, control or reduce air, water or land pollution.

Credit Amount: The credit is equal to 25% of the cost of the real or personal property, not to exceed \$25,000. This is less than the maximum amount allowed for the Pollution Control Device Credit, the primary difference being that the expenses qualifying for the Pollution Control Device Credit must be as a result of meeting rules or regulations adopted by the U.S. EPA or the Arizona DEQ or a political subdivision. Therefore, the Agricultural Pollution Control Equipment Credit is more the result of voluntary actions.

Cost: For tax year 1999, there were too few claimants to allow release of any information on the amount of credit claimed. The review of other tax years has not revealed any claimants of this credit.

Evaluation:

<i>Competitiveness:</i>	None of the targeted states have a similar credit.
<i>Social Policy:</i>	Given the minimal use of this credit by corporate taxpayers, it is unlikely that it has had any significant impact on agricultural pollution in Arizona.
<i>Economic Development:</i>	This credit was not intended to promote economic development.
<i>Compliance:</i>	Records that must be kept to claim this credit are not burdensome to the corporate taxpayer.
<i>Administration:</i>	Department of Revenue administrative costs are minimal.

⁶ This does not include credits for which carry forward can still be claimed but the credit is repealed. This includes the Agricultural Water Conservation Credit, the Construction Materials Credit, the Donation of Motor Vehicles to Work Program Credit, the Recycling Equipment Credit and the Alternative Fuels Credits.

Pollution Control Device Credit

Statute: A.R.S. § 43-1170

Purpose: A credit can be claimed for property purchases, real or personal, used in the taxpayer's business in Arizona to control or prevent pollution. Property that qualifies includes the portion of a structure, building, installation, excavation, machine, equipment or device and any attachment or addition to or reconstruction, replacement or improvement of that property that is directly used, constructed or installed for the purposes of meeting rules or regulations adopted by the U.S. Environmental Protection Agency, the Department of Environmental Quality or a political subdivision to prevent, monitor, control or reduce air, water or land pollution.

Credit Amount: The credit is equal to 10% of the purchase price or \$500,000, whichever is less.

Cost: For tax year 2000, \$3.2 million in new credit and \$6.2 million in carry forward was claimed on 30 tax returns. Tax liability of \$3.6 million was offset by the credit, resulting in a carry forward for 2001 of \$5.8 million.

Since the creation of this credit through tax year 2000, 67 corporations have claimed it. Over this time period, \$24.8 million in credit has been created.

Evaluation:

<i>Competitiveness:</i>	Oregon has a corporate income tax credit that relates to pollution control.
<i>Social Policy:</i>	The expenses that are offset by the credit are required to meet federal, state or local standards. It is likely that the larger claimants of this credit would have made the expenditures to meet the standards regardless of the credit. It is possible, however, that the smaller businesses claiming the credit may not have complied without the incentive of a credit.
<i>Economic Development:</i>	This credit has not attracted new businesses to Arizona. It is possible that this credit has had some impact on encouraging corporations to stay or expand in Arizona since this type of credit is not widely offered in the targeted competitor states.
<i>Compliance:</i>	Records that must be kept to claim this credit are not burdensome to the corporate taxpayer.
<i>Administration:</i>	Costs involved in creating forms and processing the returns are minimal. Administrative costs for this credit have been high because of a surge of claims in the last couple years. ⁷

Solar Hot Water Plumbing Stub Outs and Electric Vehicle Recharge Outlets Credit

Statute: A.R.S. § 43-1176

Purpose: A credit is allowed for solar hot water plumbing stub outs or electric vehicle recharge outlets installed in one or more houses or dwelling units constructed by the taxpayer. The credit may be transferred from the builder to the purchaser of the house or dwelling unit.

⁷ A few consulting firms interpreted the statute differently than in the past and, as a result, many amended returns were filed. This interpretation extended the definition of pollution control equipment to include equipment on vehicles. This interpretation was denied by the Department.

Credit Amount: The credit cannot exceed \$75 for each installation per separate house or dwelling unit.

Cost: No claims for this credit have been found for 1998 or 1999. Too few claims were made for tax year 2000 to allow disclosure of the information.

Evaluation:

<i>Competitiveness:</i>	None of the targeted states have a similar credit.
<i>Social Policy:</i>	Given the minimal use of this credit by corporate taxpayers, it is unlikely that it has had any significant impact on solar stub outs or electric vehicle recharge units being offered in Arizona homes. The credit has also not been passed through to the individual taxpayer; in the three years for which the Department of Revenue has reviewed this credit (1998, 1999 and 2000), the highest number of individual claimants has been 35.
<i>Economic Development:</i>	This credit is not applicable to economic development.
<i>Compliance:</i>	Records that must be kept to claim this credit are not burdensome to the corporate taxpayer.
<i>Administration:</i>	Department of Revenue administrative costs are minimal.

Underground Storage Tanks Credit

Statute: A.R.S. § 43-1173

Purpose: A credit is allowed for expenses incurred by a corporation which is not liable or responsible for a corrective action as an owner or operator of an underground storage tank, for corrective actions taken with respect to the release of a regulated substance from an underground storage tank.

Credit Amount: The credit is equal to 10% of the amount spent to take any corrective action certified by the Arizona Department of Environmental Quality.

Cost: Since 1994, three taxpayers have claimed the credit but too few have claimed it in any given year to allow release of the information. Over the eight-year period, however, less than \$5000 credit has been used.

Evaluation:

<i>Competitiveness:</i>	Florida has two credits relating to hazardous waste or contaminated sites.
<i>Social Policy:</i>	Given the minimal use of this credit by corporate taxpayers, it is unlikely that it has been an impetus to corporations to clean up areas around underground storage tanks before corrective actions are required.
<i>Economic Development:</i>	This credit is not applicable to economic development.
<i>Compliance:</i>	Records that must be kept to claim this credit are not burdensome to the corporate taxpayer.
<i>Administration:</i>	Department of Revenue administrative costs are minimal. The Arizona Department of Environmental Quality also has administrative responsibilities for this credit, in that they must certify the completed corrective action.

Credits Enacted for Economic Development Purposes Four credits can be grouped together because they relate to economic development.

Defense Contracting Credit

Statute: A.R.S. § 43-1165 and 1166

Purpose: This is actually two credits in statute. These credits are limited to companies that have been certified by the Arizona Department of Commerce as qualified defense contractors by June 30, 2001. Certification is valid for five consecutive taxable years, so no new credits can be claimed after tax year 2006.

One credit is for a net increase in employment of qualified employees under a United States Department of Defense (USDOD) contract or for a net increase in private commercial employment due to positions transferred from exclusively defense related activities to exclusively private commercial activities.

The second credit is for a portion of property taxes paid on commercial or industrial property.

Credit Amount: For net increases in employment, the credit is \$2500 for each first year full-time equivalent position created, \$2000 for the second year, \$1500 for the third year, \$1000 for the fourth year and \$500 for the fifth year. The credit for property taxes paid is determined first by calculating 40% of the property tax if more than 900 new full-time equivalent positions are created, 30% of property taxes for 601 to 900 positions, 20% for 301 to 600 positions and 10% for up to 300 positions. This amount is then multiplied by the percentage determined by dividing the taxpayer's total gross income from USDOD contracts apportioned to Arizona by the taxpayer's total gross income from all sources apportioned to Arizona.

Cost: Since the creation of this credit, six taxpayers have claimed it. In four of the eight years for which information is available, data cannot be released either because of too few claimants or one dominant taxpayer among several small claimants. In tax year 2000, three taxpayers claimed employment credit of \$7.5 million and property tax credit of \$1 million. Only \$2.8 million of this credit was used. (This means the companies claiming the credit had too little tax liability to use all the credit.)

Over the eight-year period, almost 10,000 employees were claimed for the first year of employment, 7,500 in the second year, 5,700 in the third year, 1,800 in the fourth year and less than 400 in the fifth year of employment.

The total liability offset over the eight year period for the six corporate claimants is \$10.7 million, with \$15 million in carry forward available at the end of 2000. The last new credits can be claimed in 2006 and carry forward can be claimed through 2011.

Evaluation:

<i>Competitiveness:</i>	None of the targeted states have a similar credit.
<i>Social Policy:</i>	Given that the intent of this credit was to assist corporations in a period of time when defense contracts were significantly decreased and to keep these corporations in Arizona, then the intent was probably met. However, all firms that were eligible for the credit did not take advantage of it.

<i>Economic Development:</i>	This credit has not attracted new businesses to Arizona. It may have had an impact, however, in keeping some large corporations here or in encouraging expansions.
<i>Compliance:</i>	Records that must be kept to claim this credit may be burdensome to the corporate taxpayer.
<i>Administration:</i>	Department of Revenue administrative costs are minimal. Although the Arizona Department of Commerce can no longer certify businesses for this credit, there are still administrative responsibilities which they must perform relating to qualified defense contractors.

Enterprise Zone Credit

Statute: A.R.S. § 43-1161

Purpose: This credit is allowed for net increases in qualified employment positions of Arizona residents by a business located in an enterprise zone, except where more than 10% of the business conducted at the location consists of selling tangible personal property at retail. There are a number of requirements to claim the credit, including 35% of the employees with respect to whom a credit is claimed must reside in an enterprise zone (located in the same county at the business is located) on the date of employment, the position must be at least 1,750 hours per year and so on.

According to the Arizona Department of Commerce, the Enterprise Zone program was created as a business expansion and attraction tool. It was particularly targeted to areas of high unemployment and high poverty. Enterprise zones are determined according to requirements set out in statute. The current map can be found at www.azcommerce.com/Business/ez%20home%20page.html. Based on data from the 2000 Census, the Department of Commerce expects a material change in the size and locations of the zones. The new zones will be announced in January 2004.

There is also a property tax component of the Enterprise Zones program, in which the property taxes of businesses located in the Enterprise Zone are reduced. This is not reviewed here because this reduction in tax occurs at the local level. The Department of Revenue releases a report annually on September 30 that quantifies the cost of the property tax reduction.

Credit Amount: The credit is equal to ¼ the taxable wages paid to a qualified employee, not to exceed \$500 in the first year of employment, 1/3 of taxable wages not to exceed \$1,000 in the second year of employment and ½ of taxable wages not to exceed \$1,500 in the third year of employment.

Cost: The most recent corporate income tax data for 2000 showed 59 claimants, claiming credit for businesses in 90 locations. There were 2,379 new employees claimed and total new credit of \$5.8 million. These corporations had \$3.5 million in tax liability against which the credit could be used, leaving a carry forward from this and prior years of \$6.9 million.

Since the beginning of this credit, tax year 1990, 159 taxpayers have claimed it. These taxpayers have claimed 17,108 jobs⁸ over the ten years, for a total credit amount of \$38.6 million. Over the ten year period, business at 267 separate enterprise zone locations have claimed credits. Of these

⁸ This is a count of first year jobs claimed.

267 locations, 91 were in Phoenix, 62 were in Tucson, 28 in Tempe, 11 in Flagstaff, 10 in Glendale, 10 in Yuma and the remaining 55 locations were in 26 other areas in Arizona.

Evaluation:

<i>Competitiveness:</i>	Every targeted state has a similar credit.
<i>Social Policy:</i>	This credit may have been a factor in the decision-making process for corporations when looking to expand within the state or when looking for warehouse or distribution center sites.
<i>Economic Development:</i>	Although a review of tax credit claimants would indicate that this credit program has not been responsible for bringing new corporations into the state, the Arizona Department of Commerce indicates that it has had conversations with several corporations that indicate that the program has been a significant factor for bringing new corporations to the state.
<i>Compliance:</i>	Records that must be kept to claim this credit may be burdensome to the corporate taxpayer. The Department of Commerce notes, however, that although the record keeping may be burdensome, it is important that state government has sufficient data and information to make policy decisions regarding changes to the programs.
<i>Administration:</i>	<p>General enterprise zone credit claims are not administratively a problem for the Department of Revenue. However, several accounting firms have started marketing this credit to corporations located in enterprise zones but unaware of the credit program. This has created a significant backlog of amended returns. As a result, costs have been higher for this credit than for any other. (The statute was changed in 2002 so that prospectively companies cannot take credits through amended returns.)</p> <p>The Arizona Department of Commerce has considerable administrative responsibilities relating to this credit, from determining where the enterprise zones are located to working with businesses interested in the credit.</p>

Environmental Technology Facility Credit

Statute: A.R.S. § 43-1169

Purpose: A credit is allowed for expenses incurred in constructing a qualified technology manufacturing, producing or processing facility. The facility must be used predominantly to do a variety of things set out in statute that involve recycled materials or renewable energy. The facility must cost an aggregate of at least \$20 million of new capital investment in Arizona within five years after construction begins or commencement of installation or improvements.

This credit was originally created to bring a corporation to Arizona that recycled paper. The corporation was indicating some interest in western Arizona at a site that was on or near the Colorado River. The corporation ultimately decided to locate that facility elsewhere.

All qualified environmental technology facility sites must have been certified by the Department of Commerce by June 30, 1996. Approximately 15 sites are currently certified by Department of Commerce. Unfortunately, there is no time frame by which this initial construction must start.

Construction on these sites will entitle the corporation to the credit, whether the construction begins next year or in 50 years. Furthermore, legislation passed in the 2003 session specifically allowing the certification to be passed on to acquiring companies means that the certification will never expire.

Credit Amount: The credit is equal to 10% of the amount spent during the taxable year to construct the facility, including land acquisition, improvements, building improvements, machinery and equipment, but cannot exceed 75% of the tax liability.

Cost: The number of claimants in both 1999 and 2000 were too few to allow release of information regarding this credit. Over the period 1993 through 2000, almost \$58 million in credit has been created by the seven taxpayers that have claimed it, but slightly less than \$21 million in tax liability was offset. All taxpayers claiming this credit were in Arizona prior to creation of this credit.

Evaluation:

<i>Competitiveness:</i>	No targeted states have a similar credit.
<i>Social Policy:</i>	Based on the credit claimants, it does not appear that environmentally-friendly behavior was enhanced due to this credit.
<i>Economic Development:</i>	This credit was not successful in bringing the targeted corporation to Arizona. No new corporations have been brought to Arizona as a result of this credit. The Arizona Department of Commerce indicates that there is anecdotal evidence indicating that this credit may have been helpful in retaining a few companies in Arizona.
<i>Compliance:</i>	Records that must be kept to claim this credit may be burdensome to the corporate taxpayer.
<i>Administration:</i>	Department of Revenue administrative costs are minimal.

Military Reuse Zone Credit

Statute: A.R.S. § 43-1167

Purpose: A credit is allowed for net increases in employment of full-time employees working in a military reuse zone and who are primarily engaged in providing aviation or aerospace services or in manufacturing, assembling or fabricating aviation or aerospace products. This credit is also allowed for dislocated military base employees, which are civilians who previously had permanent full-time civilian employment on the military facility as of the date the closure of the facility was determined under federal law. Although this credit was effective for taxable years from and after 12/31/93, no military reuse zones were designated until 1996.

This credit was established to lessen the impact of military base closures. There are now two military reuse zones designated: Williams Gateway Airport, formerly Williams Air Force Base; and, Phoenix/Goodyear Airport, formerly the U.S. Naval Air Facility in Goodyear. In addition to the income tax credit, the companies are eligible for property tax reductions and prime contractor exemption from the transaction privilege tax.

Credit Amount: For each employee that is not a dislocated military base employee, the credit is \$500 in the first year of employment and increases in \$500 increments for each year of full-time employment until it reaches \$2500 in the fifth year. For dislocated military base employees, the credit amount starts at \$1000 in the first year of employment and increases in \$500 increments each year until it reaches \$3000 in the fifth year of employment.

Cost: Data for tax year 2000 contains three claimants for this credit, claiming eight employees. Credit for new employees was \$109,000; \$6,440 of this was used to offset tax liability. The carry forward was \$130,262 as of the end of tax year 2000 filings.

Since 1996, four taxpayers have used this credit, claiming creation of slightly more than 80 jobs. At this point, no credits for dislocated workers have been claimed.

Evaluation:

<i>Competitiveness:</i>	California has a credit similar to this one.
<i>Social Policy:</i>	This credit does not appear to have had a significant impact in encouraging businesses to locate in military reuse zones based on the minimal number of corporations claiming the credit.
<i>Economic Development:</i>	No new corporations have been brought to Arizona as a result of this credit. The Arizona Department of Commerce indicates that low usage of the credit may be in part due to required substantial state, local and federal infrastructure investments. Additionally, the Department of Defense will do another round of base closure considerations in 2004, so the credit may be useful at that point in time.
<i>Compliance:</i>	Records that must be kept to claim this credit may be burdensome to the corporate taxpayer.
<i>Administration:</i>	Department of Revenue administrative costs are minimal. The Arizona Department of Commerce, however, has significant administrative responsibilities relating to military reuse zones, from helping to establish the zones to working with taxpayers interested in the zones or qualifying for the incentives.

Credits Created for Other Purposes The six remaining credits have a variety of purposes.

Agricultural Preservation District Credit

Statute: A.R.S. § 43-1180

Purpose: This is a *refundable* credit for taxpayers who own agricultural property and who convey ownership or development rights to an agricultural preservation district. No district can award credits exceeding \$10 million. These districts were set up to encourage that land adjacent to military bases be set aside for agricultural purposes.

Credit Amount: The amount of this credit is either the appraised value of the property if the taxpayer conveys ownership to the district or the difference between the appraised value of the undeveloped land and the appraised value of the land for development purposes if the taxpayer conveys the development rights of the property to the district. No credit can exceed \$33,000 in a calendar year.

Cost: This credit was first available for taxable years beginning from and after 12/31/00. Although credit information for tax years beyond 2000 has not yet been compiled, there have been no agricultural preservation districts formed yet. Therefore, no credit can be claimed.

Evaluation:

<i>Competitiveness:</i>	None of the targeted states have a credit similar to this.
<i>Social Policy:</i>	No agricultural preservation districts have been formed so this credit

	cannot have achieved its goal of preserving land around military bases.
<i>Economic Development:</i>	No new corporations have been attracted to the state as a result of this credit. No additional jobs or investment in Arizona seem to have occurred that can be attributable to this credit.
<i>Compliance:</i>	Records that must be kept to claim this credit are probably not burdensome to the corporate taxpayer.
<i>Administration:</i>	No information is available yet.

Employment of TANF Recipients Credit

Statute: A.R.S. § 43-1175

Purpose: A credit is allowed for net increases in qualified employment of recipients of temporary assistance for needy families who are Arizona residents. To qualify for a credit, several conditions must be met including that all employees must reside in Arizona and be TANF recipients, must be employed full time, must have insurance coverage if such coverage is offered to non-TANF employees, must receive minimum wage or a wage comparable to that received by non-TANF employees and must have been employed at least 90 days during the first year.

Credit Amount: The credit is equal to $\frac{1}{4}$ the taxable wages paid to a qualified employee, not to exceed \$500 in the first year of employment, $\frac{1}{3}$ of taxable wages up to \$1000 in the second year of employment and $\frac{1}{2}$ of taxable wages up to \$1500 in the third year of continuous employment.

Cost: In tax year 2000, five corporations claimed this credit for 71 new employees. The new credit claimed was \$33,659, with \$27,548 being used to offset tax liability. Carry forward remaining (including carry forward from prior years) was \$9000.

In the three years this credit has been available, six taxpayers have claimed it. For the same period, 273 positions have been claimed, for a total credit of \$119,000.

Evaluation:

<i>Competitiveness:</i>	New Mexico and Colorado have similar credits.
<i>Social Policy:</i>	At this point, 273 employees that were TANF recipients have been hired by the six firms. It is impossible to say whether or not these employees would have been hired regardless of the credit, although the firms involved generally have low wage, unskilled jobs.
<i>Economic Development:</i>	Based on a review the credit claimants, no new corporations have been attracted to this state due to this credit. None of the credit claimants would have left the state were there no credit offered.
<i>Compliance:</i>	Records that must be kept to claim this credit may be burdensome to the corporate taxpayer.
<i>Administration:</i>	Department of Revenue administrative costs are minimal.

Research & Development Credit

Statute: A.R.S. § 43-1168

Purpose: This credit is for research and development expenses. The Arizona Department of Commerce indicates that the credit was created because the “technology revolution has created a

hyper-competitive global economy that will be characterized in the coming decade by an accelerated pace of product development, requiring constant research and development.”

Credit Amount: The credit is computed as follows:

1. Add the excess of qualified research expenses for the taxable year over the base amount, to the basic research payments determined.
2. If the sum is less than or equal to \$2.5 million, the credit is 20% or a maximum of \$500,000.
3. If the sum is greater than \$2.5 million, the credit is \$500,000 plus 11% of the amount exceeding \$2.5 million.

If the taxpayer has qualified research expense carry forward from taxable years beginning before 1/1/01, the expenses convert to credit by multiplying expense carry forward by 20%. The amount of the credit carry forward from taxable years beginning from and after 12/31/02 that may be used in a taxable year may not exceed tax liability after subtracting current year credit. Credit carry forward from taxable years beginning before 1/1/03 that can be used in a year is limited. The carry forward amount from the specified tax years must be less than or equal to the lesser of tax liability less current year credit (thereby zeroing out liability) or the difference between \$500,000 and the current year credit.

Cost: In tax year 2000, 88 claimants have been recorded thus far. These 88 claimants indicated \$776.6 million in research and development expenses in 2000, which turns into \$15.6 million in credit. About \$6.5 million in credit was used to offset liability. The credit value of all expense carry forward is \$302 million; however, the law restricts usage of credit carry forward to \$500,000 in a tax year. Therefore, it is unlikely that this \$302 million will ever be used.

In tax year 2000 and prior years, the amount of credit that could be used was limited to \$500,000. The limit became \$1.5 million for tax year 2001, \$2.5 million for tax year 2002 and was removed for tax years beginning from and after 12/31/02. Therefore, the cost of this credit is expected to increase significantly, possibly by as much as \$20 million.

Evaluation:

<i>Competitiveness:</i>	All of the targeted states have a similar credit.
<i>Social Policy:</i>	It is difficult to judge whether the existence of this credit has actually caused more research and development activity than would have occurred without the credit. For many of the corporations claiming the credit, research and development is a necessary component of their business.
<i>Economic Development:</i>	No new corporations have been attracted to Arizona as a result of this credit. The credit may, however, been a consideration in some corporate decisions, such as retaining Arizona locations or growth at Arizona locations.
<i>Compliance:</i>	Records that must be kept to claim this credit may be burdensome to the corporate taxpayer, particularly in relation to the amount of carry forward available.
<i>Administration:</i>	The complexity of this credit makes it difficult to administer, particularly with respect to the amount of carry forward available. It is costly to both administer and verify.

School Site Donation Credit

Statute: A.R.S. § 43-1181

Purpose: A credit is allowed for donation of real property and improvements to a school district or a charter school for use as a school or as a site for the construction of a school. To qualify for the credit, the real property and improvements must be in Arizona, must be conveyed unencumbered and in fee simple, except that the property shall only be used as a school or construction site for a school.

Credit Amount: The amount of the credit is 30% of the value of the real property and improvements donated by the taxpayer.

Cost: Insufficient data has been gathered on credits claimed for tax year 2001 to provide any figures as to the cost of this credit.

Evaluation:

<i>Competitiveness:</i>	None of the targeted states have a credit similar to this.
<i>Social Policy:</i>	No conclusion can be reached at this time.
<i>Economic Development:</i>	This credit does not pertain to economic development.
<i>Compliance:</i>	Records that must be kept to claim this credit are probably not burdensome to the corporate taxpayer.
<i>Administration:</i>	The administration of this credit thus far has not been difficult.

Taxes Paid for Coal Consumed in Generating Electrical Power Credit

Statute: A.R.S. § 43-1178

Purpose: A credit is allowed for purchases of coal consumed in generating electrical power in Arizona. The following information is from a fact sheet prepared by the Arizona Senate staff when this bill was up for consideration:

"Four of the nine electricity-producing corporations in the state of Arizona use coal for production. According to Tucson Electric Power, all Arizona corporations that use coal in the production of electricity are purchasing and taking delivery of the coal in states other than Arizona. In doing this, excise tax liability associated with these purchases is shifted from Arizona to the other states, as is the tax revenue. The counties where coal purchases were previously made within Arizona...have suffered significant revenue losses. This is associated with both county excise taxes and state transaction privilege tax distributions. A loss is also realized by the general fund.

This legislation provides corporations that purchase coal in...Arizona, for use in producing electricity, an income tax credit equal to 30% of the transaction privilege or use tax paid. This is an incentive to restore the coal purchases, and corresponding revenue collections to Arizona and the affected counties....."

In other words, the credit was created to keep certain Arizona counties from losing tax revenue and revenue sharing dollars.

Credit Amount: The credit is equal to 30% of the amount paid by the seller or purchaser as transaction privilege tax or use tax with respect to the coal sold to the taxpayer.

Cost: In the three years for which data is available for this credit (1998, 1999 and 2000), five taxpayers have claimed the credit. Over the three-year period, nearly \$1.5 million in credit has been used to offset tax liability and about \$800,000 in carry forward has been created.

Evaluation:

<i>Competitiveness:</i>	Colorado has a similar credit.
<i>Social Policy:</i>	It cannot be known whether or not this credit has provided the incentive needed to electric companies to continue to purchase their coal from Arizona sources. It can be said that companies generating electricity in Arizona are using the credit, so some coal is still being purchased in Arizona.
<i>Economic Development:</i>	This credit does not pertain to economic development.
<i>Compliance:</i>	Records that must be kept to claim this credit are probably not burdensome to the corporate taxpayer.
<i>Administration:</i>	Department of Revenue administrative costs are minimal.

Technology Training Credit

Statute: A.R.S. § 43-1179

Purpose: A *refundable* credit is allowed for providing technological skills training to not more than 20 of the taxpayer's employees.

Credit Amount: The credit is equal to 50% of the amount actually spent during the taxable year for the cost of the training, but not more than \$1500 per employee. The total amount of credit that can be granted is \$2.5 million.

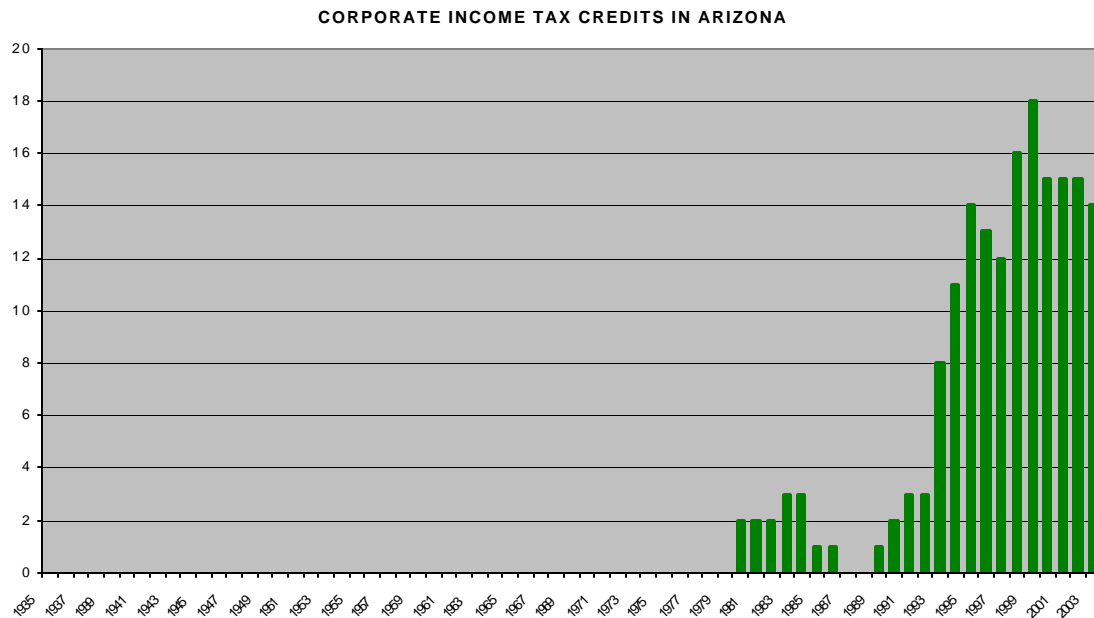
Cost: This credit first became available for tax year 2001 (and will end for tax years beginning before 2006). No data has been gathered for tax year 2001 at this time.

Evaluation:

<i>Competitiveness:</i>	Georgia has a similar credit.
<i>Social Policy:</i>	No conclusion can be reached at this time.
<i>Economic Development:</i>	No conclusion can be reached at this time.
<i>Compliance:</i>	Records that must be kept to claim this credit may be burdensome to the corporate taxpayer.
<i>Administration:</i>	Administration of this credit by the Department of Revenue has not proved difficult thus far. The Arizona Department of Commerce is responsible for certifying to the corporations the amount of credit that they are eligible to claim.

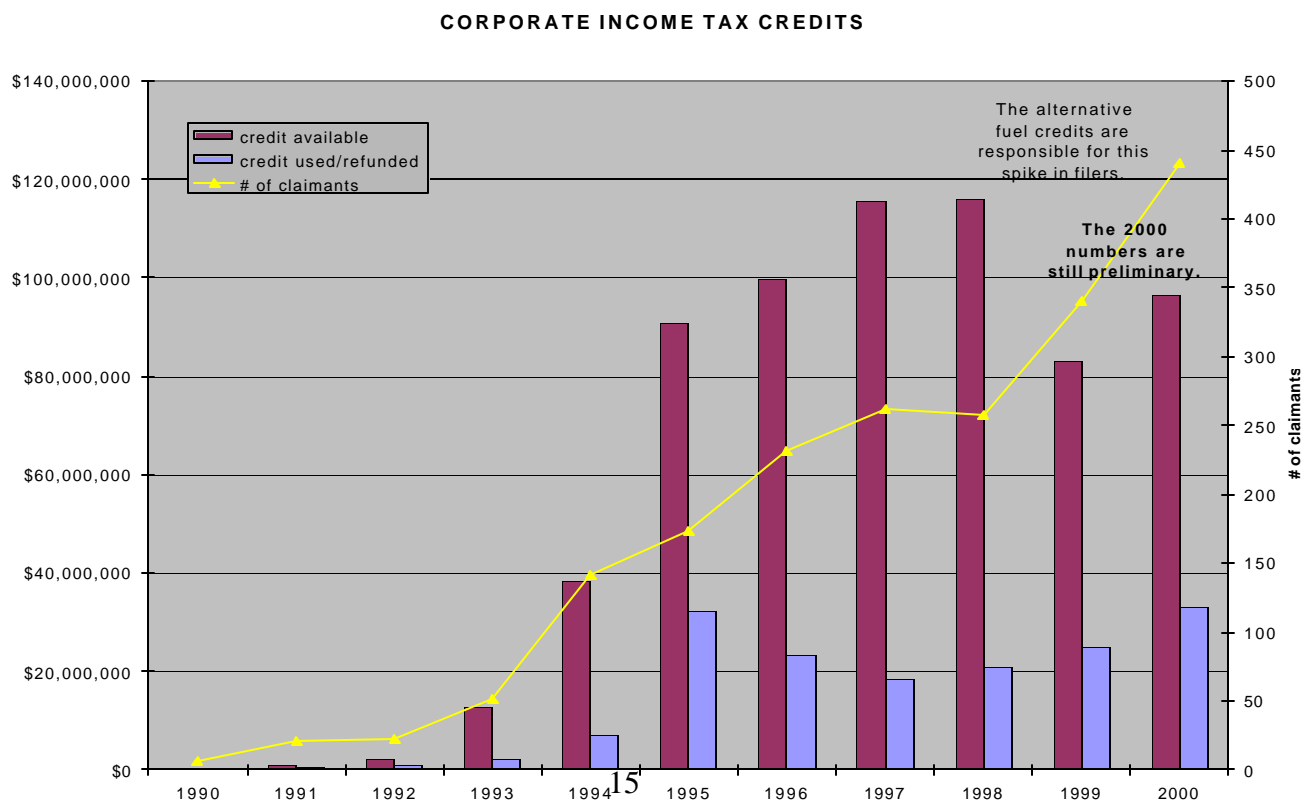
4. RECOMMENDATIONS

Tax credits do not appear to be effective tools in Arizona for promoting specific behaviors, yet the growth of tax credits in the last decade has been great. The following table illustrates that prior to 1981 there were no corporate income tax credits.



The peak number of credits was in 1999, with 18 credits available. In 2003, 14 credits are available to corporations. By 2007, there will be 12 credits available.

Similarly, the amount of credit granted to corporations, as a reduction of tax liability or even as a refund for some credits, has increased tremendously since 1990. The following table presents the number of claimants and amount of credit used, as determined at this point.



Many of these corporate income tax credits seem to have been ineffective in furthering the tax policy goals for which they were passed. (Some individual companies may have promoted the expected or desired behavior, but this was not widespread among corporations.) A good example is the alternative fuel vehicle credits. Legislation that created these credits did not anticipate the level of revenue that would be lost by the state. Furthermore, the infrastructure was not in place to allow extensive use of alternative fuels and the vehicle refueling apparatus credit did not succeed in rapidly expanding the existence of refueling stations.

As stated on Page 2 of this report, corporate credits do not promote horizontal equity, vertical equity, revenue stability for the state, simplicity, predictability, efficiency or reliability. Therefore, they should be used very selectively. The following table summarizes the success of each of the credits on the five criteria set out in Section 2 of this report. Keep in mind, however, that “success” is relative. The Department of Revenue would tend to see success at least in part by the number of corporations that claim the credit; if there are very few corporations claiming the credit, then the credit doesn’t significantly affect corporate behavior. On the other hand, the Department of Commerce may disagree with this method of evaluation; perhaps the number of credit claimants doesn’t truly provide a good picture of the number of corporations actually affected.

Credit	Do targeted states offer a similar credit?	Achieved social policy goal?	Economic development goals furthered?	Reporting burden to corporations ?	Administrative burden?
Agricultural Pollution	No	Unlikely	Not Applicable	No	No
Agricultural Preservation District	No	No	Unlikely	No	No
Defense Contracting	No	Unlikely	Possibly	Possibly	ADOR-No ADOC-Possibly
Employment of TANF Recipients	Two do	Unlikely	No	Possibly	No
Enterprise Zone	All of them	Possibly	Possibly	Possibly	Yes
Environmental Technology Facility	No	Unlikely	Possibly	Possibly	ADOR-No ADOC-Possibly
Military Reuse	One does	Unlikely	Unlikely	Possibly	ADOR-No ADOC-Possibly
Pollution Control	One does	Possibly	Possibly	No	Yes
Research & Development	All of them	Possibly	Possibly	Possibly	Yes
School Site Donation	No	Unknown	Not Applicable	No	No

Solar Stub Out/Electric Vehicle Recharge	No	Unlikely	Not Applicable	No	No
Taxes Paid for Coal Consumed	No	Possibly	Not Applicable	No	No
Technology Training	No	Unknown	Unknown	Possibly	No
Underground Storage Tank	No	Unlikely	Not Applicable	No	No

Of the fourteen credits currently in place, the Research and Development Credit and the Enterprise Zone Credit have the best record in the first three columns set out in the table above. Although they tend to be an administrative burden to the Department of Revenue, if the goals of the credits are desirable and are being met then the administrative burden would be secondary.

Most of the credits rated “Unlikely” in the Targeted Behavior or Activity column have extremely small participation as credit claimants. There are a few places where “Unknown” was entered because there has been insufficient data at this time to make a determination.

For any credits in law, there could be a case made for relaxed disclosure laws for the recipients of the credits. It is difficult to determine the effectiveness of a credit if information concerning usage of the credit cannot be released.